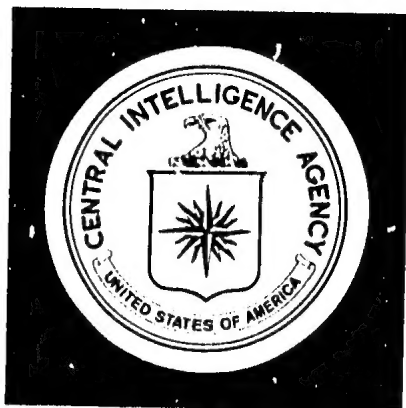


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Argentina: Impact of Peronist Economic Policies on US Investors ER IM 75-11

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Intelligence Memorandum

*Argentina: Impact of Peronist Economic
Policies on US Investors*

Confidential
ER IM 75-11
June 1975

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**Argentina:
Impact of Peronist Economic
Policies on US Investors**

KEY JUDGMENTS

Populist and nationalist economic policies during the two years of renewed Peronist rule have undermined the financial position of US subsidiaries in Argentina, contributed to nationalization of a few, and dried up the flow of US direct investment.

- Discriminatory price and wage policies have slashed profits of large firms, including most US subsidiaries.
- Two US oil companies have been forced out of domestic oil marketing, and the properties of six US-owned banks have been nationalized.
- A new foreign investment code has limited profit remittances and capital repatriation and has restricted the scope of activities open to foreign firms.

The financial problems of US subsidiaries stem from the Peronist commitment to increase labor's share of the national income. This commitment was initiated by President Hector Campora – Peron's stand-in, elected in May 1973. It was continued by Peron following his September 1973 election and, since his death in July 1974, by Mrs. Peron.

Argentine wage and price policies since mid-1973 have cut heavily into business profits. Earnings of larger businesses in particular, including most US subsidiaries, dwindled under the pressure of higher costs, and many had to turn to their parent firms for operating capital.

Soaring wage bills have been accompanied by growing public sector deficits, higher consumer demand, and record imports. Balance-of-payments problems were

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postponed, however, as good grain harvests and high world prices generated record exports and restored foreign exchange reserves. Real GDP growth climbed from 3% in 1972 to a peak of more than 6% last year.

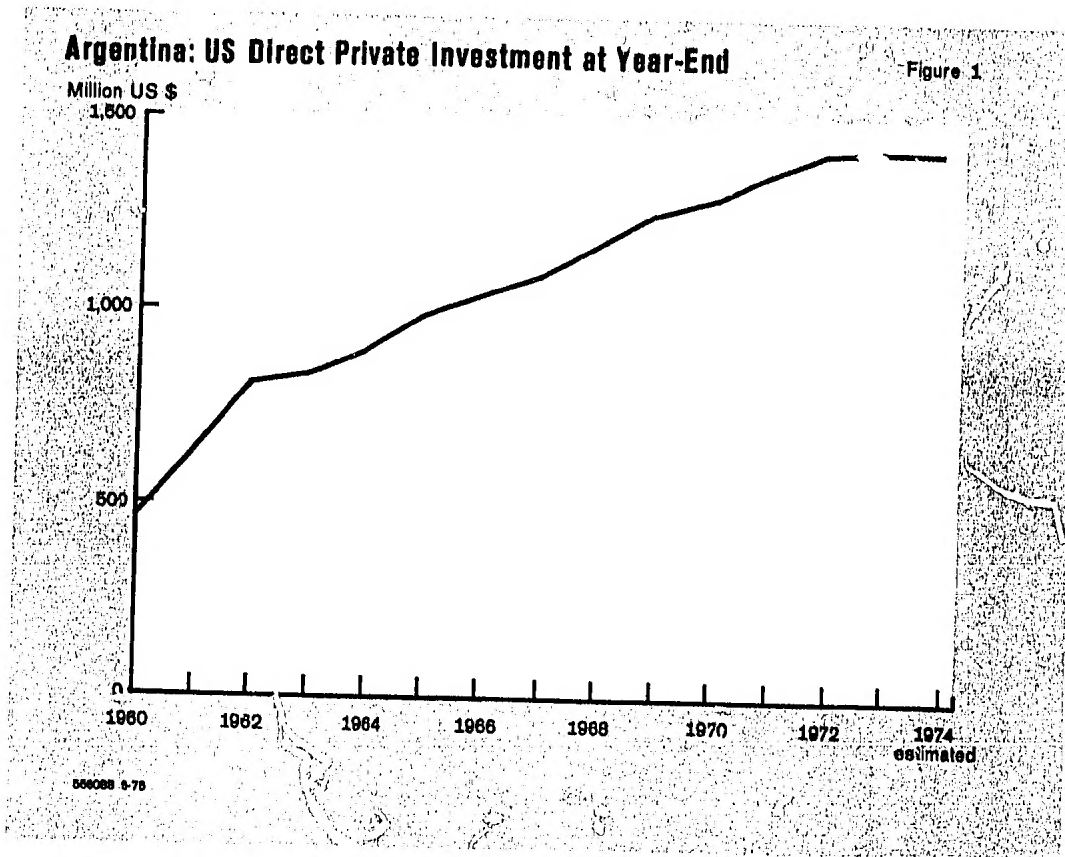
The world commodity boom that had bolstered Argentina's export earnings during 1973 and the early part of 1974 ended almost as quickly as it began, and the nation's reserves began a steady decline after mid-1974. Continuing neglect of agricultural policy and disincentives to private capital formation further slowed economic activity.

While labor and consumers enjoyed significant gains during the booming first 18 months of Peronist rule, business and foreign investors had been under steady strain. As overall economic conditions have deteriorated, US subsidiaries face even more serious problems. Profits are again under pressure from strict import and price controls and rising wage bills. Organized labor is showing renewed vitality and militancy under stress, and increasing political and economic demands are likely in the months ahead. Widening shortages and growing consumer unrest will also make producers, particularly foreign-owned subsidiaries, prime targets for nationalistic attacks, and demands for nationalization of additional US firms are likely to increase.

Most US firms will continue to absorb their losses as best they can while gradually liquidating their equities. This gradual, passive liquidation will continue so long as cash flow exceeds current outlays in the hope that the Argentine investment climate will improve. Political and economic conditions in Argentina can be expected to continue to deteriorate. This could force firms to abandon facilities and trigger government expropriations.

DISCUSSION

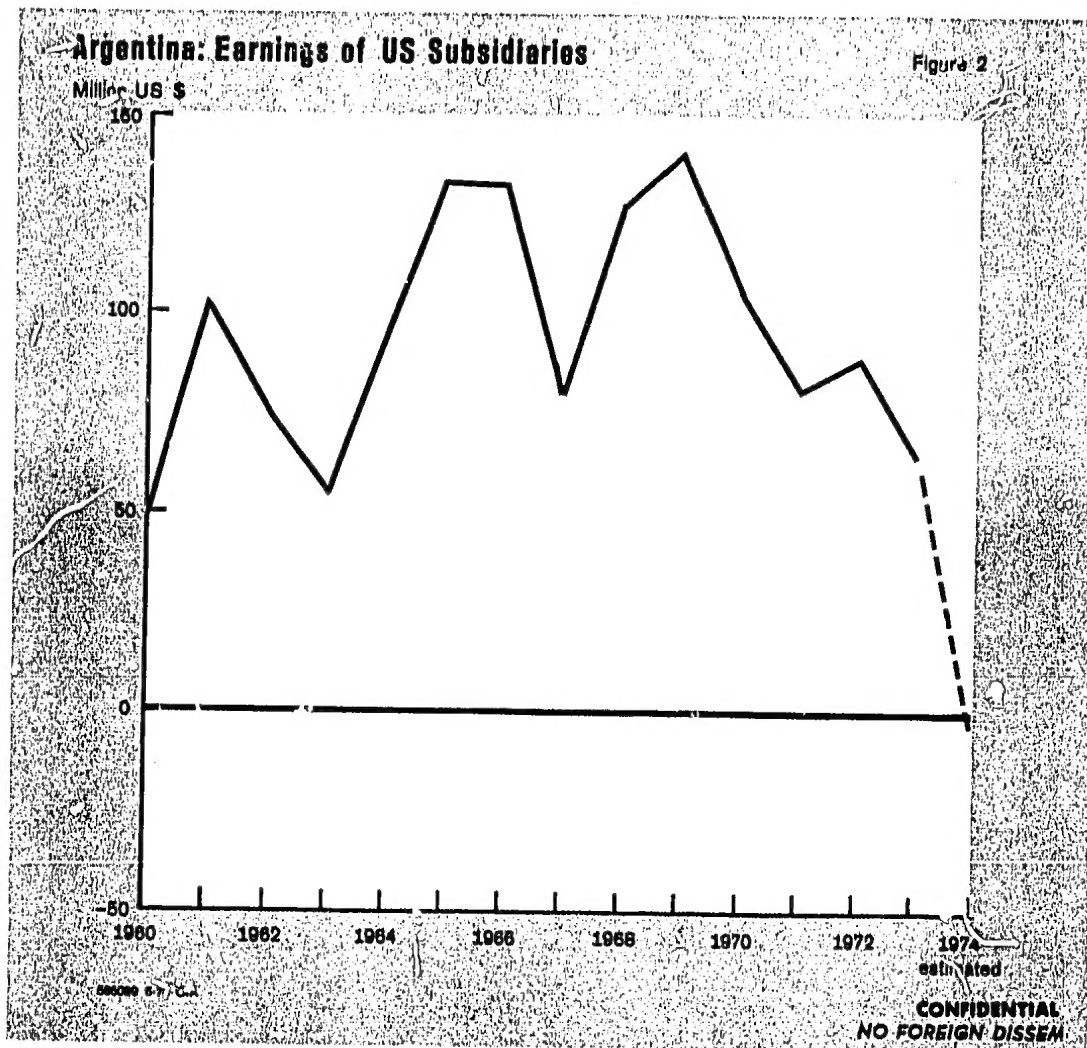
1. Government promotion of import substitution in manufacturing, a substantial domestic market, and a plentiful supply of skilled labor have attracted sizable inflows of direct foreign investment into Argentina. At present, direct foreign investment totals more than \$3 billion, including some \$1.4 billion held by US firms (see Figure 1). While this is about three times the \$472 million in US equity



present in 1960, investment in Argentina has grown more slowly than for Latin America as a whole. Roughly 60% of US investment is concentrated in manufacturing. Foreign firms currently dominate the automotive, pharmaceutical, and electrical equipment industries and, together with state enterprises, have significant equities in other heavy industries and oil refining.

2. Although the conservative military government that preceded Peron maintained a generally favorable political environment for foreign investors, the economic situation of US subsidiaries deteriorated after 1969. Economic growth slowed after 1969 as bad harvests drastically cut agricultural income. While output

of manufactures continued to grow about 7% annually with the aid of government subsidies, earnings declined as spiraling inflation stimulated exorbitant wage demands and triggered frequent work stoppages. As a result, earnings of US subsidiaries fell from a peak of \$140 million in 1969 to \$89 million in 1972. The return of Peronism then brought further declines (see Figure 2).



The Peronist Economic Program

3. The labor-based government of Juan Peron returned to power after an 18-year hiatus with a commitment to redistribute income in favor of urban workers, bring inflation under control, spur economic growth and employment, and increase Argentina's share of the benefits from foreign investment. The keystone to this policy has been the Social Pact, worked out by Peronist supporters in business and labor during the campaign preceding the May 1973 election. Under the pact,

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small and medium-size business has grudgingly supported price controls, minimum wage increases, and fiscal policies aimed at increasing labor's share of the national income from an estimated 36% in 1972 to 48% in 1977. Business furnished this support in exchange for a two-year moratorium on collective bargaining, which was to end the wage-price spiral and curb work stoppages.

4. The government's policy of fighting inflation while stimulating growth and redistributing income has come into serious conflict. The main instrument for combating inflation quickly emerged in the form of widespread price controls, which stimulated black markets and distorted production and distribution. While halfhearted attempts were made to hold down government spending and increase revenues, these policy objectives were quickly sacrificed for more socially oriented and politically appealing goals. A sweeping tax reform introduced in 1973 did little to increase revenues but did strengthen tax enforcement and boost taxes on corporations and wealthy individuals. Public utility rates were hiked to cover higher energy costs and make public utilities more nearly self-supporting. The increases, however, led to higher wage settlements while industrial consumers of energy were forced to absorb most of the increased costs. Income redistribution and real wage policies have almost always taken precedence over combating inflation and stimulating sound economic growth.

5. The government expanded public sector investment and increased outlays for social programs in order to increase employment and accelerate economic growth. Buenos Aires also attempted to boost exports of manufactures by increasing subsidies to producers and establishing special lines of credit for foreign customers. Most striking of the latter was a six-year, \$1.2 billion credit extended to Cuba in August 1973 for the purchase of automobiles, industrial equipment, and other manufactures. While all these measures stimulated demand, government threats against recalcitrant producers were needed to induce increased output because earnings continued to decline as higher costs and fixed prices ate up profits.

6. Despite the drive for accelerating economic growth, the Peron administration stepped up pressures against foreign-owned corporations in an attempt to increase local control of foreign investment and to appease Argentine nationalist sentiments. Shortly after taking office, the government initiated steps to nationalize the properties of six US banking subsidiaries. In September 1974 it turned over domestic oil distribution and retailing networks belonging to foreign firms, including subsidiaries of Exxon and Cities Service, to the state oil company, YPF. At present, Standard Electric of Argentina, the local ITT subsidiary, and Siemens of Germany are under threat of expropriation unless the firms reimburse the state

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telecommunications entity for alleged fraud and overcharges on contracts totaling \$230 million. The two firms have an investment of only \$240 million.

7. The major measure against Argentine subsidiaries of foreign-owned corporations, however, has been the foreign investment law enacted in February 1974. The law limits profit remittances to 12.5% of registered capital, compared with a rate of 14% for much of Latin America, and further restricts capital repatriation. The law requires that Argentines own at least 80% of new ventures; exceptions are granted only with executive or congressional approval. Existing subsidiaries must gradually sell their shares to Argentine citizens until they achieve majority control. Subsidiaries are given the option – thus far exercised by all 1,500 foreign subsidiaries – of avoiding the latter provision by paying a heavy surtax on profits.

Accomplishments and Failures

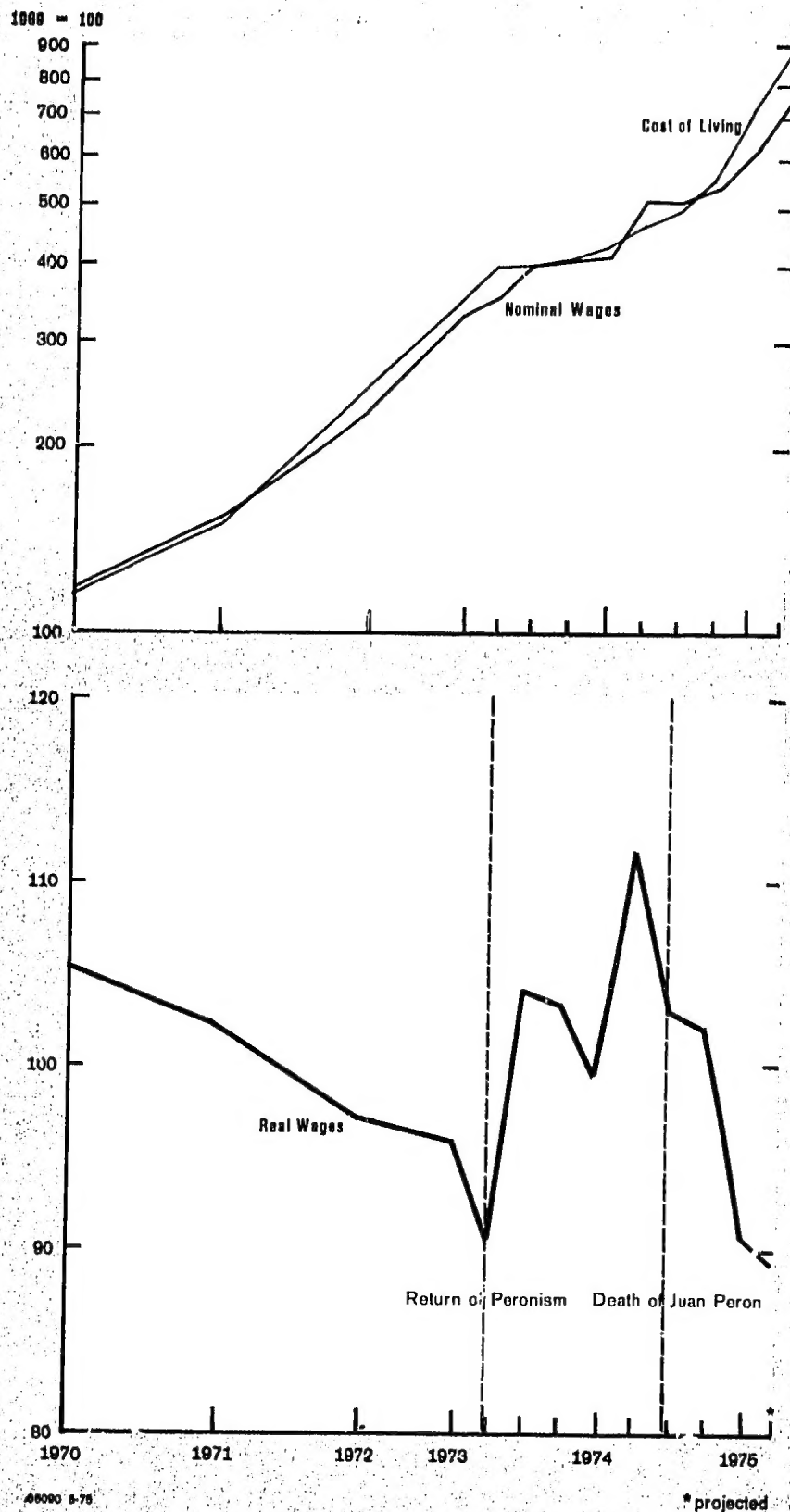
8. The Peron government has achieved relatively little of its ambitious economic program. Thanks to a large increase in export prices and a temporary recovery in agricultural production in 1973 and 1974, government revenues and foreign reserves increased greatly, economic growth accelerated, and unemployment was sharply reduced. Nevertheless, labor's share of national income gained little, and the inflation rate is now running at a 132% annual pace – significantly ahead of the May 1973 rate. Measures to increase domestic benefits from foreign investment, rather than accomplishing their objectives, have combined with price and wage measures to seriously undermine the financial position of foreign subsidiaries. Part of the failure stems from the leadership drift following Peron's death and Mrs. Peron's succession to the presidency in July 1974. The government's main difficulties, however, stemmed from its heavy reliance on rigid price controls to accomplish its wage and income objectives at a time of rapidly rising world market prices for the imported raw materials, fuels, and intermediate products required to sustain Argentine industrial production.

Wages, Prices, and the Supply of Goods

9. The new government moved quickly upon taking office to make good its income redistribution promises by cutting sharply into business profits. In June 1973 it instituted a combination of sweeping price freezes, selected price rollbacks, and a 20% across-the-board wage increase. These measures cut the inflation rate from an annual pace of 95% to 16% for the remainder of the year and also increased real wages more than 10% during the same period (see Figure 3). This dramatic

Argentina: Price and Wage Trends

Figure 3



improvement stimulated consumption and accelerated growth of GDP from 3.8% in 1972 to 5.4% for 1973. Profits, however, declined under the pressure of higher wages, frozen prices, and a 47% increase in the cost of imported inputs. As a result, returns on US direct investment declined from an average of 6.5% in 1972 to 4.5% a year later, and profits of Argentine businesses also declined to roughly two-thirds their former level.

10. In the face of falling profits, black markets burgeoned and supplies of goods at controlled prices dwindled rapidly toward the close of 1973 as producers discontinued less profitable lines and customers snapped up inventories. To ease the supply situation, the government in March 1974 authorized across-the-board price hikes averaging about 7%. Labor was again granted wage hikes in April, July, and November totaling about 40% while prices remained basically frozen at the March levels. Finally, in November, prices were permitted to adjust to non-wage cost increases incurred since 1973, but this led to another round of labor demands that culminated in a hike of around 20% in March of this year. The cycles of wage and price increases have produced little sustained improvement in either supplies of goods or real wages yet have seriously distorted the distribution system. Although real wages gained an average of 6% in 1974, the gain was largely eaten away by March 1975, and production in key industries had already begun to decline.

11. The pressure from multiple wage hikes in 1974 was exacerbated by another 40%-50% rise in import prices. In response, the government introduced a variety of stop-gap measures to improve the supply of goods and services while holding down prices. Among the measures tried were subsidized exchange rates for critical imports, selected tariff exemptions, establishment of a state enterprise to contract for and sell selected imports at subsidized prices, and finally, in June 1974, legislation enabling the executive branch to intervene directly in the operations of individual firms in the interest of maintaining "adequate supplies." These measures not only failed to eliminate the market distortions and losses to producers emanating from the price freeze but also added greatly to the costs and problems of doing business, as each new measure was accompanied by further bureaucratic entanglement and confusion. The net result was continued shortages and growing losses for business. US investors as a group may have actually lost \$5 million or more on their Argentine holdings during 1974.

Balance-of-Payments Constraint

12. Argentina's long-term growth – and indirectly the profitability of direct foreign investment – has been repeatedly constrained by balance-of-payments crises and the availability of foreign exchange. Because of Argentina's continued

dependence on agriculture for some 80% of foreign exchange earnings, trends in trade and payments are primarily triggered by changes in world commodity markets. The major achievements of the Peronist government – accelerated growth and increased employment – were made possible by fortuitous improvements in weather and in world agricultural prices. High world grain and meat prices combined with improved harvests generated a record trade balance in 1973, which provided the foreign exchange needed to cover both enlarged budget deficits and increased domestic consumption (see the table). Although new investment and industrial profits dwindled during the period, output and sales gained from the upswing in consumer demand, reflecting the growth of real wages and, beginning in 1974, a large rise in public investment spending for housing and infrastructure. Thus manufacturing output continued to grow almost as rapidly as in earlier years.

Argentina: Balance of Payments

	Million US \$			
	1972	1973	1974 ¹	1975 ²
Exports (f.o.b.)	1,941	3,266	3,553	3,000
Imports (c.i.f.)	1,905	2,235	2,882	2,900
Trade balance	36	1,031	671	100
Net services	-259	-315	-323	-300
Current account	-223	716	348	-200
Capital account	51	-45	-310	-400 ³
Private (net)	71	82	-110	-150
Public (net)	-65	-85	-150	-200
Banks (net)	45	-42	-50	-50
Change in reserves	-172	671	38	-600

1. Preliminary.

2. Projected.

3. Assumes capital inflows of \$2.3 billion and outflows of \$2.7 billion, including \$1.2 billion in public and \$1.5 billion in private debt amortization.

13. For sound development, the Peronists should have channeled at least part of the improved resource flows deriving from the improvement in external accounts into productive capital formation. Instead, they used the entire windfall to finance social and economic reform. Escalating wage payments and public sector outlays led to sharply increased government deficits in 1973 and 1974. Even with higher taxes on business and the shifting of profits to labor and consumers, the government was forced to step up borrowing abroad and continued to rely heavily on central bank financing of deficits. This only added to the squeeze on private enterprise. Foreign firms in particular were forced to go abroad for needed financing. Thus

tight credit plagued corporate enterprises in spite of a doubling of the money supply in 1973 and further growth of more than 60% in 1974.

14. In the best of circumstances the boom fostered by the Peronist government could not have been long sustained. In fact, the deterioration of the world beef market in 1974, higher raw materials prices for industry, and the softening of world prices for grains in late 1974 hastened the day of economic reckoning. Argentina now faces foreign debt service payments equivalent to 40% of export earnings; and the nation's reserves, after reaching a peak of \$1.2 billion in July 1974, slipped to \$746 million by the end of December. By the end of the first quarter of 1975, deteriorating terms of trade and capital flight dropped net foreign reserves to about \$100 million, and no recovery is in sight. This, of course, leaves the foreign investor with an even more gloomy prospect.

Impact on US Subsidiaries

15. Peronist economic policy has seriously undermined the position of foreign investors. Although government price and wage policies have hurt all large firms, increased taxes and restrictions under the new foreign investment laws have greatly intensified the pressure on the profits and liquidity positions of foreign subsidiaries. For example, the Pepsicola subsidiary, which together with Coca-cola dominates the Argentine soft drink industry, has reportedly lost about \$10 million from operations since mid-1973, and losses by Coca-cola apparently are comparable. Difficulties of the foreign-owned automotive firms have been particularly striking. The industry as a whole showed a net loss of more than \$160 million in 1974; the three US majors accounted for \$70 million of this. Rapidly rising costs now are causing losses even on automobile export sales to Cuba despite continued government subsidies and mandatory export quotas. Automobile output is currently declining at an annual rate of about 4%.

16. Restrictions on borrowing by foreign firms have aggravated financial pressures, and US subsidiaries have been forced to defer capital replacements to cover operating expenses. Indeed, many have been forced to turn to their parent firms to replenish working capital. US parent firms have begun to meet these persistent financial drains by shutting off funds, forcing some subsidiaries into near bankruptcy. Most US subsidiaries have sought to minimize losses and to continue production for fear of nationalization under duress or expropriation. The government has already begun nationalization of an ITT subsidiary, and pressure is mounting to take over private petroleum refineries.

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17. In addition to financial pressures, US firms have been hurt by the deteriorating political and security situation in Argentina. Despite the two-year moratorium on wage negotiations, firms have been plagued by wildcat strikes, labor violence, and extra-legal wage settlements. Nearly all US subsidiaries have been the target of terrorist action, and security considerations have shrunk the resident business community to probably less than 100 US citizens. The exodus of US managers has led to a loss of managerial control. The presence of terrorist elements, rival political factions, and rival unions within the plants and offices of US subsidiaries has resulted in growing labor disruptions, slowdowns, and even sabotage. Since business interests exert the least influence on the Peronist political scene, producers have been forced to absorb the resulting increased costs and loss in productivity. Many US firms have been forced to maintain their output under threat of expropriation even though productivity has declined as much as 40% since 1973 and financial losses have eroded their capital base.

Outlook

18. The situation of US companies in Argentina will probably grow worse over the next year or so. The likelihood of overt moves against US interests will increase as the antibusiness stance of Peronist supporters and growing political unrest force the government to take drastic steps to divert attention from the growing domestic difficulties. The Peronists' failure to meet income redistribution targets will probably force the government to continue tight price controls for most of 1975 while granting renewed rounds of wage hikes. As a result, the squeeze on profits probably will tighten. No policy reversal can be expected unless dramatic drops in production exacerbate consumer unrest to the point of threatening Mrs. Peron's government. Even then, a successor government is unlikely to loosen restrictions on, or to embrace a larger role for, foreign capital.

19. The economic and political advantages enjoyed by business in general and US investors in particular before the return of the Peron government have disappeared. Retrenchment of private investment is eroding industrial capacity. Reduced crop production and lower world market prices are undermining balance-of-payments prospects. And the political consensus of the Peronist government is dwindling. Economic growth will probably decline during the latter part of the year as constraints on industrial capacity come increasingly into play.

20. The options of the foreign investor in Argentina are seriously circumscribed in the present situation. Most firms appear to have resigned themselves to gradual erosion of their equities over the coming months. While most

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can be expected to continue operations as long as possible to avoid violent repercussions from labor and expropriation by the government, gradual liquidation of equities is in fact taking place through failure to replace equipment on a normal basis. Even so, this process of liquidation is generally a long-term process, and few companies are expected to force a confrontation unless earnings drop below current out-of-pocket costs.

21. The balance of payments appears to be Argentina's most critical problem for 1975 and 1976. Foreign exchange earnings are falling rapidly as world commodity prices and lower crop production cut Argentina's vital grain export receipts. Although the 33% devaluation of the peso in March 1975 may help bolster sagging exports of manufactures, continued recession in the developed countries and the depressed world beef market will probably keep total export earnings some \$600 million behind last year. Even with strict import controls, purchases abroad will total about \$2.9 billion. These elements, combined with heavy debt service obligations, will probably reduce foreign exchange reserves by \$600 million or more.

22. Increasing import curbs may force Argentina to pay a heavy price in stagnating or even declining industrial production over the next 12 to 18 months. The resulting increases in unemployment and losses in real income could bring serious political problems for Mrs. Peron's already shaky government. Officials could increasingly turn to attacks on foreign interests to court Argentina's basic xenophobia and to divert attention from its deteriorating domestic scene. Such an event would quickly turn the foreign investment picture from difficult to impossible.